Mandatory Social Security

Joint Hearing of

Assembly Public Employees, Retirement and
Social Security Committee
Chair: Assembly Member Lou Correa

and

Senate Public Employment and Retirement Committee
Chair: Senator Deborah Ortiz

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Presented by:

The California State Teachers' Retirement System

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

MANDATORY SOCIAL SECURITY

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Mandatory Social Security

Presentation by Jennifer DuCray-Morrill,
Chief External Affairs Officer
California State Teachers' Retirement System

I am Jennifer DuCray-Morrill, Chief External Affairs Officer for the California State Teachers' Retirement System (CalSTRS). I would like to thank you for holding this hearing today to discuss a federal issue of great importance to CalSTRS, CalPERS and many other public pension plans and public employees.

The Social Security Trust Fund is expected to have insufficient funds to meet its obligations by 2032; therefore, comprehensive Social Security reform is being formulated now to ensure the continued viability of the Social Security system. We anticipate that legislation to provide financial stability to the SSTF will be introduced in Congress in the near future.

Mandating Social Security coverage for all newly hired non-covered state and local government employees has been suggested by some as one of the possible options for financing Social Security reform. However, the Government Accounting Office acknowledges that mandating Social Security coverage on newly hired non-covered public employees extends the solvency of the SSTF for only two years.

When Social Security was established in 1935, state and local government workers were precluded from participating because it was considered unconstitutional for the federal government to tax state and local governments. Instead, public employers established their own retirement plans in lieu of Social Security. In fact, CalSTRS was established in 1913, long before Social Security was created.

In 1954, the Social Security program was amended to allow coverage voluntarily by public employees – even if they were covered by a state pension plan. The choice was up to the states, subject to a majority vote of the members of the plan. A vote was conducted for all members of CalSTRS in 1955. The election resulted in rejection of Social Security on full-time teaching by a 4 to 1 margin.

CalSTRS has almost 400,000 active teachers working for 1,100 school districts. Mandating teachers into Social Security will have a significant impact on employers - and employees as well. School districts will have to respond in one of a number of ways:

1.) Pay an additional 6.2% of payroll for Social Security on top of employer costs required to fund CalSTRS. This alternative is projected to cost school districts $3.8 billion dollars in the first 10 years of implementation. If the school district has to absorb the cost of the employee’ s 6.2% tax, this cost would double.

2.) Request that the Legislature reduce CalSTRS benefits to a level that when combined with Social Security benefits would equate to the current level of benefits provided by CalSTRS.

If Social Security is substituted for a large portion of the current CalSTRS benefit, total contributions for retirement benefits will have to increase substantially in order to fund the same level of benefits as currently provided by CalSTRS. CalSTRS has calculated these costs at over 7% of payroll. Based upon our current estimated teacher payroll, the increase will be over $1 billion per year and increasing over time with growth in payroll.

If employees are required to share these increased costs, the impact of mandating Social Security would result in a salary reduction of nearly 10% (6.2% SS tax plus 3.5% increased retirement costs).

3.) Request that the Legislature reduce CalSTRS benefits to that which can be funded within current contribution levels after funding mandatory Social Security contributions - balance of 1.8%

Employers cannot provide an adequate benefit with the funds remaining after paying mandatory Social Security contributions. Teachers would be required to reduce their standard of living in retirement. How are employers suppose to attract qualified and talented teachers into a profession that can't provide adequate retirement benefits?

CalSTRS has recently conducted as study that demonstrated its benefits were among the lowest in the country. This study was used as a basis for increasing CalSTRS benefits through legislation passed by the Legislature last year. Mandatory coverage could adversely impact the effect of those benefit increases.

Mandatory Social Security coverage will have a devastating effect on California’ s ability to implement education reform measures such as class size reduction. The increased payroll tax from mandatory Social Security coverage would come at the direct expense of education programs, benefits and services for students and employees in California.

This new tax is a shift of a federal government burden to local communities to solve a federal problem which state and local governments had no hand in creating and under which there will be no benefit paid to affected workers for more than a generation. Compelling state and local governments to participate in the Social Security system provides no benefit to these public employers, school districts or students nor does it resolve the long term funding problems facing Social Security.

Although the President’ s budget proposal did not contain a provision mandating Social Security coverage on newly hired public employees, legislation is expected to be considered in Congress this year which may include such a proposal. As mandatory Social Security will have its largest impact upon public employers in California, it is critical that the State’ s position be known.

SOCIAL SECURITY BENEFITS AND CalSTRS MEMBERS
(Updated excerpt from Teacher' Retirement Board material for September 11, 1997)
Revised February 1999

Mandatory Social Security for New Employees

Introduction:

Another movement is underway to extend Social Security coverage to all new state and local government employees. The enactment of such a proposal would have a major fiscal impact on new California teachers and employers, and on the California State Teachers' Retirement System (CalSTRS). Currently, members and employers are paying 16% of payroll toward the System's total cost rate of 19.876% of payroll. The required contribution for Social Security for new hires would be 6.20% of payroll from both new hires and their employers. Adding the new Social Security contribution of 12.40% on top of the 19.876% total cost rate would create a total required contribution rate of 32.276% of payroll for new hires.

The CalSTRS defined benefit program is designed as a fully independent program with a 2% at age 60 retirement benefit plus ancillary disability and survivor benefits. The addition of Social Security on top of this program will create an overlap of disability and survivor benefits and create a joint benefit, which could be considered excessive by many. Therefore, mandatory Social Security coverage for new teachers could necessitate the closure of the current CalSTRS program to new members and the enactment of a new, lower cost CalSTRS program that complements the Social Security program. *(It should be noted that while in some states, including California, there are judicial or constitutional guarantees against reductions in retirement benefits for public employees, these guarantees would not necessarily apply to "new hires".)*

In 1980, in a report commissioned by Congress, the Universal Social Security Coverage Study Group established that mandatory Social Security coverage would result in the transfer of significantly higher retirement costs to state and local governments. The report included a study by 13 independent actuaries, which analyzed retirement plans of independent state systems, and proposed new benefits and costs for those systems coordinated with Social Security. The overall actuarial costs of the proposed plans, including Social Security taxes and assuming approximately equal benefits, would have increased on the average of 5% to 8% of payroll.

However, mandating Social Security on public employees is a recurring threat because Congress sees mandatory coverage as a way to reduce federal budget deficits. While Social Security and Medicare are considered trust funds, contributions to the system are considered revenues when measuring the federal budget deficit.

Following is a historical background on Social Security, and some consequences of mandating Social Security on new hires.

Historical Background:

1935 Social Security was established originally as a modest retirement system for employees of private industry as the Old Age and Survivors Insurance program (OASI). Employees of state and local government were excluded from coverage when Congress passed the Social Security Act. This was because of the constitutional question of levying the employer portion of the Social Security tax on state and local government.

1951 Public employees that were not in positions covered by a state or local retirement system were given the option of joining Social Security. Eight states overcame the restriction of no coverage in a retirement system dissolving the existing retirement system, obtaining Social Security coverage for the jurisdictions' public employees and then reinstating the retirement system with either the same or revised provisions. Coverage under the new state system was usually mandatory for new hires in the eight states.

1954 The Social Security program was again amended to make coverage voluntary to public employees even if they were covered by a state plan. The choice was up to the states, subject to a majority vote of the members of the plan. If Social Security coverage was elected, it was an all or nothing choice; that is to say all employees would be included.

1955 In California, an every-member vote was conducted by the California Teachers Association (CTA). *(It should be noted that in 1955 the makeup of employee organizations was much different than it is today, e.g., administrators were members of CTA.)* The election resulted in rejection of Social Security on full-time teaching by 4 to 1.

1956 Entry into Social Security was made even easier. Coverage could be extended to employees who wanted the coverage, while those who did not desire coverage could be excluded, if all newly hired employees were automatically covered. This provision was eventually extended to 20 states, including California (State legislation was passed for school classified and state employees to be covered under this provision in 1959 and 1961, respectively).

Also in 1956, the disability insurance program was added, providing income to disabled workers. The program has since been referred to as the Old-Age, Survivors, and Disability Insurance program (OASDI).

1967 Title XVIII - Medical Enrollment Act of 1967 established medical coverage for persons age 65 and older.

1977 Legislation was passed establishing the "Government Pension Offset" which reduces Social Security benefits under certain circumstances if there is a pension based on employment not covered by Social Security. The pension offset of spousal benefit, if the spouse is receiving a public retirement benefit, did not take effect until 1982 and only if the spouse was not eligible for retirement as of that date.

1983 Legislation was passed establishing the "Windfall Elimination Provision". This provides for an alternate calculation, resulting in a lower Social Security benefit, for retirees who primarily worked in employment not covered by Social Security, and who had other jobs where they paid Social Security taxes long enough to become eligible for covered benefits.

1985 Mandatory Medicare for new hires of state and local governments became law as part of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA). All new hires in California public schools after April 1, 1986 are covered by Medicare.

1986 The Tax Reform Act of 1986 made extensive amendments to Internal Revenue Code Section 401 concerning the integration of qualified retirement plans with Social Security benefits. The integration requirements were further complicated by modifications to the general plan "nondiscrimination" regulations. Integration with Social Security subjects plans to complex Internal Revenue Service regulations. Because of administrative complexities involved in the integration of Social Security, it is generally recommended that integration be avoided and that "supplemental" plans totally independent of Social Security be developed if necessary.

1988 As a result of Congressional consideration of mandatory Social Security for new hires, Chapter 743 (AB 147--Elder), which required CalSTRS to develop and submit to the Legislature an actuarially sound and funded alternative retirement plan that, when coupled with Social Security, would provide a member of CalSTRS with adequate retirement benefits.

1989 State legislation was passed that made it optional for public school employers to hold elections for Medicare coverage for active members hired before April 1, 1986. Individual members could choose Medicare coverage if the employer offered the election. The effective date of the Medicare coverage could not be earlier than January 1, 1997.

1990 As part of the Omnibus Budget Reconciliation Act of 1990 (OBRA), Congress enacted a law requiring all public employees not covered by a state or local retirement plan meeting specified standards to be covered by Social Security. This led to the development of the CalSTRS Cash Balance Benefit Program for part-time teachers.

1997 A Social Security-Advisory Council composed of 13 members recruited from business, labor and think tanks recently issued reports on the current state and future of Social Security. The Council members had widely differing views on how to solve the ongoing funding problems. But one area of agreement was that all newly hired state and local government workers should be required to pay into the program. It has been estimated that mandating Social Security coverage on new hires would raise about $16.3 billion over a five-year period.

Arguments in Opposition of Requiring Social Security for State and Local Governments and Their New Hires:

- The additional 12.40% cost for new members (6.20% for the employer plus 6.20% for the new member) would create a financial burden for California public schools and new hires. The average annual additional cost for a new hire would be at least $1,600 each for the employer and the employee. Statewide the employer portion of the cost for new hires would be at least $24 million a year. The additional required member-employer contribution of 12.40% approaches the normal cost of the current CalSTRS program (15.79%) leaving little room for the design of a supplemental retirement tier unless new funding can be found. Salary estimates come from the Department of Education's Annual J-90 Salary and Benefits Survey. This could result in the need to develop a two-tier system with new hires being covered by Social Security and a lower cost retirement plan.

- Because the Social Security program offers disability and survivor coverage components, it is unlikely that the excellent CalSTRS disability and survivor coverage could be provided to new hires if a new retirement plan were to be designed.

- State and local government plans are much more soundly funded than Social Security and provide better benefits. State and local retirement plans are able to invest in securities providing a higher return than the bonds held by Social Security. If Social Security is substituted for a large part of employees' retirement plan benefits, contributions will have to increase to fund the same level of benefits.

- The 1990 OBRA mandate required state and local employees be covered under a plan comparable to OASDI, if they are not covered by OASDI. This provided the connotation that coverage outside Social Security was appropriate.

- Coverage of new state and local workers would increase revenues to the Social Security fund for several years. However, Social Security does not have a short-term problem. Social Security has a long term funding problem because excess short term revenues are not being saved and invested to pay the accruing liabilities attributable to those revenues. If the cost of providing benefits exceeds the funding necessary to provide these benefits adding more people to the system will make matters worse, not better.

- There would be a loss of an element of control by the TRB to the federal government. The federal government controls the benefits and costs of the Social Security program. For example, benefits can and have been changed, which have adversely impacted those eligible to receive as well as those receiving Social Security benefits. The future of the Social Security program is in doubt.

California State Teachers' Retirement System (CalSTRS)

Impact of Mandatory Social Security Coverage for All New Hires

Major new payroll tax burden for school districts

If added to current pension costs, the 12.4% Social Security payroll tax cost of mandatory Social Security coverage for all new teachers would create a major financial burden for California public schools. The average additional annual cost for a new hire would be at least $1,600 each for the employer and for the employee. This increased payroll tax would result in an estimated $7 billion fiscal impact to California school districts in the first 10 years of implementation.

Employers cannot provide an adequate pension benefit after funding the Social Security payroll tax

The additional Social Security payroll tax burden approaches the normal cost of the current CalSTRS retirement plan, leaving little room for the design of a retirement benefit to supplement Social Security for the new hires, except in the unlikely event that new State and local funding can be found.

Dramatically higher costs to fund current retirement benefit levels

State and local government retirement plans produce substantially higher investment returns than Social Security. Actuarial studies show that the current CalSTRS plan produces a much greater benefit than a plan coordinated with Social Security for the same level of contribution, for essentially all combinations of age and service.

If Social Security is substituted for a large portion of the current State pension benefit, contributions to the State plan will have to increase substantially in order to fund the same level of benefits as currently provided to California teachers. CalSTRS has calculated these costs at over 7% of payroll. Based upon California's estimated current teacher payroll of $16 Billion, the increase in total cost would be $1.1 Billion per year, and increasing over time with growth in payroll. If the employer is required to absorb these costs, the impact to school districts would be doubled. If employees were required to share these increased costs, the impact of mandating Social Security would mean a reduction in salary of nearly 10 percent (6.2% SS tax plus 3.5% increased retirement costs).

Benefits to be cut, rather than costs increased

Given the fiscal and political difficulties of increasing State and local government retirement costs, it seems likely that State and local employers would respond to mandatory coverage for new hires by cutting benefits under the State and local retirement plan rather than suffering substantial increases in contribution costs.

Funded benefit replaced by pay-as-you-go

Mandatory Social Security coverage would substitute an unfunded benefit under the pay-as-you-go Social Security system for the funded retirement benefit that the new State or local worker would have received under the State or local government retirement system.

Threat to future funding status of the State Plan

As the U.S. General Accounting Office has noted in recent testimony before the House Ways and Means Social Security Subcommittee: "Mandatory coverage and the resulting changes to benefit levels for newly hired employees are likely to result in reduced contributions to the current pension plan. The impact of reduced contributions on plan finances would depend on the actuarial method and assumptions used by each plan, the adequacy of current plan funding, and other factors." (pg.10).

Even though CalSTRS is currently well funded, in the future the liabilities for the closed group of current participants could exceed assets, creating an unfunded liability. A substantial reduction in the contributions from new hires would have an adverse impact on the pay-down of any unfunded liability of the plan.

Why California Teachers Need to Care About Mandatory Social Security

"If it ain't broke, don't fix it"

After years of general talk about reforming the Social Security system, news out of Washington indicates Congress and the Administration are finally serious in their search for ways to bail out the struggling program. A common element in almost all the proposals under consideration is mandatory Social Security coverage of newly hired state and local government employees, including public school teachers.

The Teachers' Retirement Board opposes mandatory Social Security coverage. We would be asked to cast aside decades of successfully providing retirement benefits to generations of teachers, in order to force future members into a system with reduced benefits at higher cost.

Social Security has been in place for more than 60 years as a "pay-as-you-go" system. It might have been "fair" to mandate state and local governments at the start. However, it is unfair to wait until late in the game and then mandate coverage to solve long-standing solvency problems that the states had no hand in creating.

Mandated coverage for newly hired teachers would adversely affect not only those teachers, but would have far-reaching impacts on the schools, current teachers and CalSTRS itself.

Threats to Schools

- ✓ Added to current pension costs, the schools would face a 6.2 percent Social Security payroll tax cost for each new teacher. According to a CalSTRS actuarial study, the average additional annual cost for a new hire would be at least $1,600.

- ✓ School district administrators have indicated to CalSTRS that a reduction in services would be necessary in order to address the increased costs of mandatory coverage. This would mean a cut in funds for libraries, athletics and other programs.

Threats to Teacher Benefits

- ✓ Extra payroll costs could mean current teachers might see changes in their employer-provided benefits, such as decreased health care premium coverage.

- ✓ A reduction in contributions to CalSTRS due to mandatory coverage could impact future increases in benefits.

- ✓ A CalSTRS actuarial study shows the current CalSTRS plan produces a much greater benefit than a plan coordinated with Social Security for the same level of contribution. Unless additional state revenues are found, newly hired teachers would not receive the same level of benefit as teachers already hired. This would undermine the equity principle that all teachers should receive comparable benefits for the same service and pay. The resulting two-tiered caste system could potentially affect morale and present recruitment problems.

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Threats to School Budgets

✓ Added to current pension costs, schools would face a 6.2 percent Social Security payroll tax cost for each new teacher. According to a CalSTRS actuarial study, the average additional annual cost for a new hire would be at least $1,600 for the school district.

✓ School district administrators have already indicated to CalSTRS that a reduction in services would be necessary in order to address the increased costs of mandatory coverage. This could mean:
  - a cut in funds for libraries, athletics and other programs
  - decreases in employer-provided benefits for current teachers, such as health care premium coverage
  - less money for salary increases

✓ A CalSTRS actuarial study shows the current CalSTRS plan produces a much greater benefit than a plan coordinated with Social Security for the same level of contribution. Unless additional state revenues are found, newly hired teachers would not receive the same level of benefit as teachers already hired. This would undermine the equity principle that all teachers within each district should receive comparable benefits for the same service and pay. The resulting two-tiered caste system could potentially present recruitment and labor relations problems.

✓ Depending upon the definition used of "new hire," currently employed teachers, who change jobs and begin working for another district, might be affected. It is likely “new hire” would be defined as it is for Medicare, which applies not only to persons just hired, but also to persons who change from one employer to another. Given the additional costs to the teacher covered by Social Security, school districts might find it more difficult to recruit from another district.

Threats to Local Control and Flexible Benefit Management

✓ The “one-size-fits-all” approach of Social Security determined in Washington would severely affect the current retirement plan with benefits tailored to teachers’ unique work histories.

✓ School districts would lose the ability to provide input to state and local governments in managing retirement costs directly, with such costs now largely being thrust upon them from the federal government.

Threats to the Retirement System

✓ According to the U.S. General Accounting Office, mandatory coverage is “likely to result in reduced contributions to the current pension plan.” CalSTRS is currently well-funded. However, in the future, the liabilities for the closed group of current participants could exceed assets, creating an unfunded liability. A substantial reduction in the contributions from new hires would adversely affect the pay-down of any unfunded liability of the plan.

✓ A reduction in contributions to CalSTRS due to mandatory coverage could also impact future increases in retirement benefits.

The Threat is Real and Imminent

✓ Competing Social Security reform plans already are being put together by Republicans and Democrats. All the plans proposed thus far include a mandatory coverage provision.

✓ Both Democrats and Republicans have indicated they view mandatory Social Security for local and state government workers as a “cash cow” or “free money.” One White House staffer called adding coverage of these workers a “no brainer.”

✓ Once a mandatory coverage provision is in a comprehensive Social Security reform legislation package, it will be hard to get out. The objective is not to be included in such a comprehensive package in the first instance.

✓ Unless concerned teachers and teacher groups express their concerns very soon, any Social Security reform legislation adopted this year <u>will</u> likely include mandatory coverage for all new teachers.

✓ Now is the time to act. Given the lengthy process to get to this point of actually drafting Social Security reform legislation, once action is taken in 1999, it will be years before further reform will be attempted. This means that by preventing mandatory coverage now, it probably will be years before the issue is raised again.

- ✓ Depending on the definition used of "new hire," current teachers could find themselves discouraged from changing jobs. It is likely "new hire" would be defined as it is for Medicare, which applies not only to persons just hired, but also to persons who change from one employer to another. This could make changing school districts considerably less attractive for current teachers. They would then be required to pay, in addition to the 8 percent of salary to CalSTRS, 6.2 percent to Social Security.

Threats to Local Control and Flexible Benefit Management

- ✓ The "one-size-fits-all" approach of Social Security determined in Washington would severely affect the current retirement plan with benefits tailored to teachers' unique work histories.

- ✓ Teacher groups now have input on benefits through the bargaining and state legislative processes. This traditional opportunity to help manage the retirement system would be effectively curtailed with a Social Security benefit structure thrust upon them by the federal government.

Threats to the Retirement System

- ✓ According to the U.S. General Accounting Office, mandatory coverage is "likely to result in reduced contributions to the current pension plan." CalSTRS is currently well-funded. However, in the future, the liabilities for the closed group of current participants could exceed assets, creating an unfunded liability. A substantial reduction in the contributions from new hires would adversely affect the pay-down of any unfunded liability of the plan.

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